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DE RUEHBU #0070/01 0181558

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FM AMEMBASSY BUENOS AIRES

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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, January 1-11, 2008

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period January 1-11, 2008. The unclassified email version of this report includes tables and charts

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tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- 2008 Wage Negotiations: a tough road ahead
-- Tax revenues increase 39% in December, bringing full-year revenues to ARP 200 billion
-- GDP growth estimated to reach 8.5% y-o-y in 2007, leaving a strong push for 2008
-- Industrial production expected to grow 7.2% y-o-y - one percentage point below 2006
-- Year of the Auto: Argentine car production hits a record in 2007

-- GoA ban on fuel exports forces energy companies to drop domestic retail prices
-- BCRA presents 2008 Monetary Program to the Senate
-- Argentine bonds slightly positive in December, supported by local investors

Economic Policy

2008 Wage Negotiations: a tough road ahead

¶2. (SBU) One of the main risks facing the economy in 2008 is the trajectory of prices and salaries. Attention is focused on upcoming wage negotiations between unions and private companies, which generally begin in late-February and March. Union leaders have stated to local media their intention to seek wage increases on the order of 20-30%, while private companies argue they can only afford increases below 20%. A brief review of companies' expectations on 2008 salaries follows. These results are based on a survey that Sel Consultores (a think tank specialized on labor issues) conducted with one-hundred and twenty-eight companies operating in Argentina,

employing one-hundred and eighty-four thousand workers.

-- Fifty percent of the companies are preparing to negotiate wage increases during the first four months of the year. Unions at these companies are demanding wage increases of 23%. Although these companies state that they are willing to grant 17% pay increases, on average, they admitted in the survey that they expect to settle negotiations at about a 20% increase. The companies want the GoA to propose a 16% increase guideline for 2008, although they anticipate that the GoA's guidance will be in the range of 18%. In addition, 35% of company respondents predicted that Unions would reject any GoA attempts to recommend guidelines for the negotiations. For reference: in 2006 and 2007, wage bargaining agreements ended with a 22% wage increase (for each year), taking into account increases in basic wages plus non-remunerative increases. Prior to the negotiations, the GoA had suggested wage increase guidelines of 19% in 2006 and 16.5% in 2007. [GoA statistical agency INDEC's latest release showed that the salary index (CVS - coeficiente de variacion salarial) increased 22% y-o-y in November.]

-- Neither the companies nor unions considered the "official" CPI produced by INDEC as a reference for their negotiation. (INDEC measured the 2007 CPI increase at 8.5% in 2007; however, private analysts estimate 2007 CPI increased in the range of 18-24%, more than double the official estimate.)

-- Company respondents were generally of the opinion that the GoA had backed away from its stated plan to arrange a "Social Pact," in which the private sector and unions (with government guidance) would agree to salary increases for all sectors, and would also work to control price increases. During the 2007 presidential campaign, then-candidate (now President) Cristina Fernandez de Kirchner announced the Social Pact as a pillar of her post-election economic policy program, although she never gave details of how it would be implemented, although she did refer to Spain's "Moncloa Pact" as a possible guide. Companies surveyed clearly prefer to avoid the

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Social Pact structure. In the survey, they expressed a preference for the negotiation of sector-by-sector wage agreements.

-- The majority of companies surveyed responded that they expect the negotiations will eventually result in salary at or near 2007 levels, or about a 22% increase. While this would represent a significant nominal increase in employee incomes, whether it would also entail higher real incomes depends on whether (actual) inflation stabilizes or continues accelerating at the pace it did in the second half of 2007.

Argentine daily newspaper Cronista reported January 11 (without citing any source) that the GoA believes that the economy can handle a 20% salary increase without causing excessive inflationary pressures -- due to the productivity gains companies achieved last year. This increase is in line with the companies' expectations as shown in the above survey, and is on the lower end of the range of the Unions' claims.

Economic Outlook

Tax revenues increase 39% in December, bringing full-year revenues to ARP 200 billion

13. (SBU) December 2007 federal tax revenue increased 39% y-o-y to ARP 19.6 billion, above expectations of ARP 18.8 billion, bringing full-year revenues to a record of ARP 200 billion (up 33% y-o-y in nominal terms), or approximately \$63 billion. This strong yearly performance is mainly explained by strong collections of VAT (+33% y-o-y), income taxes (+27% y-o-y), and export taxes (+39% y-o-y), which together explain 75% of the tax collection. The record-setting level of revenues collected, representing 25% of GDP, was due to a combination of factors: strong economic and consumption growth, better export performance (coupled with increased export tax rates, mainly on soy and soy-byproducts, mining, and fuels), improvement in tax compliance, and high inflation.

¶4. (SBU) AFIP (equivalent to the U.S. IRS) released a special report on income tax revenues in 2007, which showed that revenues from financial intermediation service providers (mainly banks) and the construction sector increased 94% and 70% y-o-y, respectively, followed by real estate activities (up 44% y-o-y). The income tax is the second highest collecting tax (after VAT), providing 21% of the tax collection in 2007. AFIP also noted that the full-year's increase in export tax collection (+39% y-o-y) is explained by both higher quantities of exports (8%) and higher prices for exported goods (9%). In terms of tax collection on agricultural exports, the products showing the highest increases in 2007 were: soybeans (+100%), corn (+93%), soy-oil (+70%), pellets (+50%) and wheat (+33%).

GDP growth estimated to reach 8.5% y-o-y in 2007, leaving a strong push for 2008

¶5. (SBU) In the first quarter of 2007, GDP increased 8% q-o-q, slightly decelerating from 4th quarter 2006, when it increased 8.6%. However, in the second quarter of 2007, GDP accelerated again, increasing 8.7% q-o-q, pushed on the supply side mainly by the agricultural sector, which enjoyed a record year in 2007. On the demand side, consumption was the growth engine -- a result of significant increases in 2005 and 2006 in real incomes, as well as increases in disposable incomes in 2007 following cuts in income taxes and increased pension payments in GoA transfers to families (asignaciones familiares). Even though third quarter GDP data is not yet available, the EMAE (the economic activity index), a reliable indicator of GDP, increased 9.4% y-o-y in October, indicating that growth is still running strong. The BCRA consensus survey is estimating 2007 GDP growth at 8.5% y-o-y (similar to 2006 GDP growth), which would set a high floor (roughly a 3.3% statistical drag) for 2008 GDP, which the BCRA consensus survey estimates at 6.9%.

Industrial production expected to grow 7.2% y-o-y ? one percentage point below 2006

¶6. (SBU) The industrial sector appears to have closed 2007 on a strong note, with current estimates for annual growth in the sector of 7.2% y-o-y, after having decelerated strongly during the winter months (June-August ? the coldest months) due to energy shortages

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and restrictions. Since September, however, the industrial production (IP) index returned to a robust pace; in November (the latest data available), the index increased 9.9% y-o-y. Nevertheless, after November's IP release, some private analysts expressed concerns or doubts about the credibility of this index, given that INDEC, which is allegedly tampering with CPI statistics, also produces the IP index (See Nov 19, Oct 26, Oct 5, Sep 20, Sep 4, and Feb 2 Econ/Fin reports).

Year of the Auto: Argentine car production hits a record in 2007

¶7. (SBU) In 2007, the domestic car industry had its best year in history, with production reaching 544,647 units, up 26% from 2006. Automotive exports reached 316,410 units, also an all-time record, and comprising about 58% of total production. In 2007, the automotive industry accounted for almost 20% of Argentina's manufacturing output and 36% of all manufacturing exports, measured by value. The Argentine auto association ADEFA (Asociaci?n de F?bricas de Automotores) predicts that the auto industry will mark another record year in 2008, with estimated production in the range of 620,000 units (a 14% y-o-y increase), with exports projected at about 400,000 units.

Energy

GoA ban on fuel exports forces energy companies to drop domestic retail prices

¶8. (SBU) On January 7, the GOA announced a new decision to prohibit

exports of gasoline and diesel, and accompanied the declaration by strongly urging downstream energy companies to return retail prices at their gas stations to October 31, 2007 levels. Beginning shortly after the October 10 elections, fuel prices have been increasing steadily and unevenly throughout the country, due in part to the holiday season and higher crude international prices, but also a clear effort of oil companies to increase pump prices from the low levels prevailing in Argentina. According to a local energy specialist, in November the domestic gasoline price before taxes was almost 50% of the average price prevailing in Brazil, Chile, or Uruguay. In the case of diesel, it was almost 60% cheaper. With these prices and 2007 record-high sales of new cars, gasoline consumption increased to 4.9bn liters in 2007, up from 3.5bn liters in 2006. Before the ban was announced, there were fuel shortages in several provinces, with cars having to wait in long lines to get fuel and often with gas stations limiting amounts and refusing to accept credit card payments. Provincial authorities therefore took measures to guarantee the supply of diesel and gasoline in their territories, which included police inspections of gas stations.

¶9. (SBU) Interior Commerce Secretary Guillermo Moreno, known as the GoA's price-control czar and the mastermind behind manipulation of INDEC statistics, announced the ban on behalf of the government. He publicly based his decision on the so-called Supply Law (*ley de abastecimiento*), enacted in 1974 during the last Juan Peron government, which allows the GoA to take emergency measures to ensure the adequate domestic supply of just about any product. The ban was transmitted verbally to the main refineries, and was reported in the press, but was never published as a regulation.

¶10. (SBU) On Friday, January 11, the state news agency (Telam) reported that three oil companies -- Repsol YPF, ESSO, and Petrobras -- which combined provide about two-thirds of the gasoline and diesel in the country, had "agreed" to roll down the prices of liquid fuels back to their October 31, 2007 levels. As a quid pro quo, the GoA agreed to withdraw the ban on these companies' fuel exports. [Shell reportedly refused to lower its pump prices, and is also reportedly still subject to the export ban.] Neither government officials nor the oil companies specified by how much gasoline or diesel prices would drop due to this accord. Private analysts estimate that it could potentially result in a 15-20% cut from the prices prevailing in late 2007. Some analysts also said that a negotiated outcome was expected, since the fiscal impact of the ban due to the reduction in fuel export taxes revenues would have amounted to an estimated \$1.35 billion in 2008. Year to November, refined fuels exports increased 14% with respect to the same period of 2006, to US\$3.4 billion, largely thanks to a 100% y-o-y jump in November. This November increase helped to prevent a deeper fall in external energy sales, which decreased 12% in the period.

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Finance

BCRA presents 2008 Monetary Program to the Senate

¶11. (SBU) BCRA President Martin Redrado presented December 26 the Central Bank's 2008 Monetary Program to the Argentine Senate Budget and Economy Committees. During the presentation, he noted that Argentina will face a more hostile international environment (compared to previous years) due to the deceleration in the U.S. economy. However, he assessed that Argentina (as well as Latin America as a region) is well prepared to manage negative external shocks. He further estimated that global prices of Argentina's commodity exports will remain high and help the country's economy in 2008. He summarized that the 2008 monetary program will be based on three pillars: financing the extraordinary Argentine growth, strengthening the financial system, and reducing the system's vulnerabilities. Redrado took advantage of the opportunity to highlight for the Senate the BCRA's accomplishments in 2007, particularly its success in limiting the impact on the domestic market of the international financial turmoil that started in July.

¶12. (SBU) The 2008 program estimates GDP growth of 7.2% (almost twice the Budget's forecast of 4% and also higher than the BCRA consensus estimate of 6.9%), an inflation range of 7-11% (on the lower side of the Budget's 7.3% assumption, and significantly lower than private sector estimates of about 20%), investment reaching 23% of GDP (the highest level in the last decade), and M2 growth rate of 18% (below the nominal GDP growth rate and slightly decelerating from the 18.3% M2 growth rate estimated for 2007). The program also assumes that the GoA will increase the primary fiscal surplus, the trade surplus will reach about \$9 billion (compared to the \$10.2 surplus estimated for 2007), and salaries will continue an upward trend in the context of strong demand for labor. [As reported in the Dec 21 Econ/Fin report, with the higher primary fiscal surplus, the Treasury will reportedly purchase \$3-5 billion in the foreign exchange market, helping the BCRA to fulfill its 2008 monetary program and also helping the BCRA to maintain the peso at the current artificially low level of 3.15 ARP/USD.]

¶13. (SBU) Redrado noted that in an effort to provide higher certainty, the 2008 monetary program will introduce "private M2" as an additional target to total M2 [total M2 is defined as cash in circulation plus private and public sector sight-accounts (savings and checking); private M2 is equal to total M2 minus the public sector sight-accounts]. The introduction of private M2, even as an annual target (compared to total M2, monitored quarterly), should be interpreted as good news. It prevents the BCRA from using gimmicks to achieve its monetary targets, as it has done in the past by shifting public sector deposits from sight accounts to time deposits. [Note: the BCRA argues that the Argentine financial sector is not developed enough for the Central Bank to engage in inflation targeting, and instead targets monetary aggregates. The BCRA's monetary program targeted the monetary base from 2003 to 2004, but began targeting total M2 in 2005.]

¶14. (SBU) With 18% expected growth of M2, it is a stretch to call the BCRA's policies restrictive or contractionary in 2008, since maintaining the M2 growth rate below the nominal GDP growth rate does not guarantee either stable or low inflation. Coupled with the BCRA's policy of maintaining negative real interest rates, many analysts agree that overall BCRA policies are at least accommodating, if not fully stimulating, domestic consumption.

¶15. (SBU) Argentine bonds slightly positive in December, supported by local investors

The performance of Argentine dollar-denominated bonds (Discount and Par bonds from the 2005 debt exchange) improved slightly in December, as measured by JPMorgan's Emerging Market Bond Index Plus (EMBI+). The Argentine EMBI rating tightened nine basis points versus a 26 bps tightening in the general index, and 22, 29, 43 and 18 bps tightening in the cases of Brazil, Ecuador, Venezuela and Mexico, respectively. For comparison, Argentine inflation-adjusted peso bonds traded an average 7% higher, compared to a 2% increase for the dollar bonds. This positive trend for the peso bonds is mainly explained by the private sector insurance companies (AFJPs), which have started to bring in funds from Brazil and invest them in

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Argentine assets. [Note: due to a regulation change, AFJPs are expected to repatriate roughly \$2.5 billion of investments in the Mercosur area by December 2008 ? reported Oct 26 Econ/Fin report.]

EMBI	Dec 26 Tightening in December
EMBI General Index	220 -26
Argentina	389 -9
Brazil	200 -22
Ecuador	587 -29
Venezuela	481 -43
Mexico	129 -18

¶16. (SBU) Financial analysts and traders consider that Argentine bonds started to perform badly early in 2007 following the GoA's initial intervention into INDEC's inflation calculations (starting February, with January's CPI release, and worsening thereafter with

each month's CPI release), and also due to the deterioration over the course of 2007 of macro fundamentals (e.g., inflation, the election-year spending boom's adverse effect on the primary fiscal surplus, and energy shortages). Although private financial sector contacts held out some hope for change (or at least, "gradual fine-tuning") following the October 2007 presidential election, since taking office on December 10 the new administration has pursued a policy of "continuity" on economic policies. According to Embassy financial sector contacts, foreign financial sector investors remain in a "wait-and-see" mode, hoping for positive economic policy signals that convince them to bring funds into the country. The market is segmenting, with foreign investors only cautiously purchasing Argentine financial assets (and generally with an extremely short-term horizon) and local investors, such as pension funds, purchasing Argentine financial assets because they have no alternatives.

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